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No. 182

In the Supreme Court of the United States

OCTOBER TERM, 1932

PINELLAS ICE AND COLD STORAGE COMPANY,
PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 12–22) is reported in 21 B. T. A. 425. The opinion of the Circuit Court of Appeals (R. 28–31) is reported in 57 F. (2d) 188.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 29, 1932. (R. 31.) The petition for certiorari was filed June 27, 1932 (R. 32), and granted October 10, 1932. The jurisdiction of

this Court rests on Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Petitioner, a corporation, transferred substantially all its property to another corporation in return for a cash down payment and deferred installments, the latter being evidenced by notes of the transferee secured by its bonds. The question is whether the petitioner is relieved from taxation on the gain realized from the transaction by the exceptions to Section 203 (a) of the Revenue Act of 1926.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra,* pp. 33–41.

STATEMENT

The facts found by the Board of Tax Appeals (R. 13–19) may be summarized as follows:

Petitioner, a Florida corporation, was engaged in the manufacture and sale of ice. Substantially the same stockholders controlled it and the Citizens Ice & Cold Storage Company, a corporation engaged in the same business in the same locality. (R. 13.) The directors and stockholders of both companies were anxious to dispose of all the property of the two companies and then to discontinue business, dissolve the corporations, and distribute the proceeds. One Lewis, general manager of both companies, in 1926 began negotiations for the sale

of the business and property of the two companies. (R. 13.)

By written agreement of November 4, 1926, petitioner agreed to sell to the National Public Service Corporation more than 99% of its total property for $1,400,000, of which $400,000 was to be paid in 1926 and the remainder in installments during 1927. (R. 14–15, 19.) The purchaser agreed to form a new Florida corporation and to cause it to take title to the property sold. (R. 16.) The deferred installments of the purchase price were to be evidenced by notes of either the National Corporation or the new corporation, secured by the mortgage bonds of the new corporation or other satisfactory collateral. (R. 15–16.) An agreement of similar import was executed between the Citizens Company and the National Corporation. (R. 17.)

The National Corporation then organized the Florida West Coast Ice Company (R. 17), and on December 17, 1926, the transactions were closed. The petitioner and the Citizens Company delivered instruments of transfer made out to the Florida Company; cash was paid as provided; and notes of the Florida Company were given for the deferred installments. Bonds of the Florida Company secured by the properties acquired from the petitioner and the Citizens Company were given as collateral for the notes. The cash was used to pay the petitioner's creditors. The Citizens Company agreement was carried out at the same time. (R. 17–18.)

In January, 1927, pursuant to the plan theretofore made by the stockholders and directors of the petitioner (R. 18), formal resolutions for the winding up of petitioner's affairs, its dissolution and the distribution of its assets were adopted (R. 18). Similar action was taken by the Citizens Company. (R. 18.) When the Florida Company paid its notes to the petitioner, the proceeds were immediately distributed to its stockholders as liquidating dividends. After retaining a small sum to meet contingent liabilities, the remaining assets of the petitioner (less than 1%) were turned over to a holding company organized in 1927, as trustee for the petitioner's stockholders. (R. 18–19.)

The Commissioner determined that the petitioner was taxable on the profit of $552,144.12 which was realized on the transaction, and accordingly asserted the deficiency in question. (R. 6.) This action was upheld by the Board (R. 12–22) and the Circuit Court of Appeals (R. 28–31).

SUMMARY OF ARGUMENT

I

The purpose of the statute was to defer the recognition of gain or loss in any case where an exchange resulted merely in a change of form and not of substance, and all of its provisions should be interpreted to effectuate this underlying purpose. The statute first states the general rule that gain or loss on sales and exchanges shall be recognized.

The exceptions which follow deal solely with exchanges and not with sales. The transaction here involved was an outright sale and it is not therefore within any of the exceptions.

Furthermore, the transaction did not result in a reorganization within the meaning of the statute. In a reorganization under Section 203 (b) (1) (A) there must be some continuity of interest in the substantial ownership of the property involved. The notes received by petitioner clearly do not represent such a continuity of interest; therefore there was no reorganization.

The statute further requires that part of the consideration shall consist of stock or securities in another corporation a party to the reorganization. The purpose of this requirement was obviously to preserve a continuity of interest in the assets transferred, without which the interest of the transferor would be substantially changed. While the payment of part of the cash consideration in this case was deferred and represented by notes, it is clear that they do not preserve unchanged the petitioner's interest in the assets disposed of. Therefore they are not securities within the meaning of the statute.

The existence of a plan of reorganization is an essential requirement for the classification of a transaction as a tax-free exchange. Petitioner had no plan of reorganization. If there was any plan it was that of the transferee.

The statute further requires that the taxpayer shall be a party to the reorganization. This requirement, like the others, was not satisfied in this case.

The opinion of the court below is said to adopt a construction that a reorganization within the statute must be in connection with a technical merger or consolidation. We do not contend for that narrow construction, which is opposed to the administrative interpretation of the statute. In the light of the facts of this case the opinion below may be interpreted as based upon the lack of any continuity of interest such as exists in mergers or consolidations. But even if the court below in its opinion placed too narrow a construction upon the statute, its judgment was clearly right and should be affirmed.

II

The statute permits some cash to enter into a transaction without losing its character as an exchange, but it contemplates that either the corporation or its stockholders shall be taxable on the profit to the extent of the cash, depending upon whether or not the cash was "distributed." This plainly means distributed to stockholders. Petitioner received $400,000 in cash as a down payment and none of it was distributed to stockholders. Since it is clear that the profit on the transaction was in excess of $400,000, petitioner is taxable upon that amount of profit in any event.

ARGUMENT

I

THE TRANSACTION WAS A SALE OF PROPERTY FOR MONEY, AND NOT AN EXCHANGE INCIDENT TO A REORGANIZATION WITHIN THE PROVISIONS OF SECTION 203 OF THE REVENUE ACT OF 1926, AND THE ENTIRE GAIN WAS TAXABLE

Section 203 (a) of the Revenue Act of 1926 (*infra*, p. 33) provides that—

> Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

The transaction here involved was a disposition of property which admittedly produced a profit. There is no controversy with respect to the amount of the profit, the sole question being whether the petitioner is freed from taxation on it by the exceptions contained in other provisions of Section 203. It is, of course, well settled that one claiming an exemption from tax must bring himself squarely within the provisions of the statute under which he claims such exemption. The rule is equally applicable to a taxpayer who claims the benefit of exceptional treatment. *Bowers* v. *Lawyers Mortgage Co.*, 285 U. S. 182, 187.

The exemption on which the petitioner relies is contained in Section 203 (b) (3) as modified by Section 203 (e) (1). Section 203 (b) (3) (*infra*, pp. 33–34) provides that—

> No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

This provision is qualified by Section 203 (e) (1) (*infra*, pp. 35–36) which provides:

> If an exchange would be within the provisions of paragraph (3) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—
>
> (1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, * * *.

The word "reorganization" as used in the section is defined in Section 203 (h) (1) (A) (*infra*, pp. 36–37) as follows:

> The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation) * * *.

From its terms it is plain that the purpose of the statute was to defer the recognition of gain or loss in any case where an exchange results merely in a change of form and not of substance. A corporate transaction may technically involve a sale or exchange and thus have the elements of a "closed" transaction without changing in substance the real ownership of the property involved. In such a case Congress has provided that no gain or loss shall be then recognized for tax purposes and the tax is postponed.[1]

An examination of the various provisions in Section 203 just mentioned shows that before a transaction may be treated as nontaxable the following conditions must have existed concurrently:

(1) The transaction must have been an "exchange" of property (rather than a "sale");

(2) There must have been a "reorganization" within the statutory definition;

(3) The consideration must have consisted solely of "stock or securities" in another corporation party to the reorganization, or partly of stock and securities and partly of "other property or money";

(4) There must have been a "plan of reorganization";

---

[1] If it is deemed necessary to resort to legislative history for light on the Congressional purpose, that supports our view of the purpose of the statute. See pp. 22–24, *infra*.

(5) The taxpayer must have been "a party to the reorganization"; and

(6) The "other property or money" must have been "distributed" by the taxpayer corporation "in pursuance of the plan of reorganization."

We believe that none of these essential facts existed in this case and that consequently the admitted profit from the transaction was taxable to the petitioner.

(1) *The transaction must have been an "exchange" of property.* We submit, as held by the court below, that a mere sale of corporate assets is not a tax-free exchange within the intent of the statute. The taxpayer here disposed of its assets for a consideration which was to be paid only in money. The contract expressly provides that the vendor "agrees to sell" and the purchaser "agrees to purchase" the assets "for the sum of $1,400,000, payable as hereinafter provided." (R. 14.) The terms of payment are specified to be: "$400,000 in cash" on the date of closing, and the "balance of the purchase price, to wit: $1,000,000 shall be paid by the Purchaser to the Vendor" in installments of $500,000 on or before the 31st day of January, 1927, $250,000 on or before the 1st day of March, 1927, and $250,000 on or before the 1st day of April, 1927. The contract then provides that "The deferred installments of the purchase price above mentioned shall be *evidenced*" by 6% notes of the proposed Florida corporation, *secured* by the deposit as collateral

of mortgage bonds of such Florida corporation, or by "other collateral satisfactory to the Vendor." (Italics ours.) (R. 15.) In closing the transaction on December 17, 1926, these provisions of the contract appear to have been carried out in their entirety, except that the last installment of $250,000 was evidenced by two notes of $150,000 and $100,000, respectively, on account of the necessity of removing a cloud on the title to one of the properties. These notes were paid on or before their due dates, except the one for $100,000 which was paid in November, 1927, after the flaw in the title had been cleared up. (R. 18.)

Under familiar definitions of "sale" and "exchange," this transaction was clearly a sale and not an exchange. Both the form and the substance of the transaction require that conclusion. See *Williamson* v. *Berry,* 8 How. 495, 544; *Preston* v. *Keene,* 14 Pet. 133, 137; *Burnet* v. *Logan,* 283 U. S. 404, 412; *Corbett* v. *Burnet,* 50 F. (2d) 492 (App. D. C.).

The Board of Tax Appeals held this transaction to be a sale for money and not an exchange for securities within the meaning of the statute. The Circuit Court of Appeals apparently considered that the transaction was a sale and not an exchange, and we submit that the decision below may be adequately rested on that ground alone. It is clear, we submit, that Congress did not intend to postpone recognition of the gain derived from the sale of property for cash as distinguished from an ex-

change of property for stock or securities. The profit was then actually realized and no policy to base the tax on substance instead of form dictated that its taxation should be deferred. Although Section 203(e) permits some cash to enter into a transaction without causing it to lose its character as an exchange, Section 203(a) provides that the gain or loss shall be recognized from a "sale or exchange" and the exceptions which follow relate only to exchanges and in no case to sales. The distinction made in the statute between sales and exchanges should be preserved. The requirement that stock or securities in addition to cash or other property be received in exchange for the transfer of the assets is retained in the regulations. See Treasury Regulations 65 and 69, Article 1574. There is no regulation which provides that a transfer in return for cash alone is exempted from taxation by Section 203. The Board of Tax Appeals has consistently held that sales for cash are not among the exceptional cases in which the recognition of gain or loss is postponed. *Geary* v. *Commissioner,* 6 B. T. A. 1109; *Sarther Grocery Co.* v. *Commissioner,* 22 B. T. A. 1273; *Cortland Specialty Co.* v. *Commissioner,* 22 B. T. A. 808, affirmed, 60 F. (2d) 937 (C. C. A. 2d); *Warner Company* v. *Commissioner,* decided October 19, 1932, 26 B. T. A. —. See also I. T. 1410, I–2 Cumulative Bulletin 25 (December, 1922); G. C. M. 1977, VI–2 Cumulative Bulletin 168 (December, 1927).

Cortland Specialty Co. v. *Commissioner,* 60 F. (2d) 937 (C. C. A. 2d), pending on petition for certiorari, No. 482, October Term, 1932, directly supports our contention. It was there held that the term "reorganization" "does not properly embrace mere purchases by one company of the assets of another," and that "A sale of the assets of one corporation to another for cash without the retention of any interest by the seller in the purchaser is quite outside the objects of merger and consolidation statutes," and that Section 203 of the Revenue Act of 1926 "must be interpreted in this setting."

(2) *"Reorganization."*—Although the Circuit Court of Appeals in this case apparently considered that the transaction was a sale and not an exchange, it also pointed out that a "reorganization" is an essential element in any transaction which constitutes a tax-free exchange, and that although here there was an acquisition by one corporation of substantially all the property of the other, there was no reorganization because the transaction was not a merger or consolidation as those words are generally understood. It is not clear whether the court intended to hold that the statute requires a merger or consolidation in the technical sense or whether the effect of its decision is that there must be merely a continuity of interest. It said (R. 31):

> It must be assumed that in adopting paragraph (h) Congress intended to use the

> words "merger" and "consolidation" in their ordinary and accepted meanings. Giving the matter in parenthesis the most liberal construction, it is only when there is an acquisition of substantially all the property of another corporation in connection with a merger or consolidation that a reorganization takes place. Clause (B) of the paragraph removes any doubt as to the intention of Congress on this point.

The reference to clause B of Section 203 (h) (1) which recognizes as a reorganization "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred" indicates that the purport of the decision is that the statute requires that the transferor shall retain some interest in the property transferred. This construction, we submit, is correct. The statute was not designed to make tax free any transaction unless there was some continuity of interest in the substantial ownership of the property involved.

This construction is supported by the decision in *Cortland Specialty Co.* v. *Commissioner,* 60 F. (2d) 937, *supra,* where the court said (p. 940):

> Its purpose was to relieve those interested in corporations from profits taxes in cases where there was only a change in the corporate form in which business was conducted without an actual realization of any gain

from an exchange of properties. When describing the kind of change in corporate structure that permits exemption from these taxes, section 203 does not disregard the necessity of continuity of interests under modified corporate forms. Such is the purpose of the word "reorganization" in section 203 (b) (3) of the act, where a corporation exchanges its property "solely for stock or securities." Such also is the nature of the "merger or consolidation" described in subdivision (h) (1) (A) where a corporation acquires a majority of the stock of another, and such is the nature of the "reorganization" described in subdivision (h) (1) (B) of section 203, where a corporation transfers assets to another corporation and the transferor, or its stockholders, immediately thereafter are in control of the transferee. The words: "A recapitalization," in subdivision (h) (1) (C) of section 203, and "A mere change in * * * form * * * of organization, however effected," in subdivision (h) (1) (D) of section 203, involve the same idea.

Moreover, such a construction carries out the general theory of the statute, for while Section 203 permits the gain from a tax-free exchange to be temporarily ignored, Section 204 requires that the new property received shall be considered as taking the place of the old property given in exchange, for the purpose of determining the gain or loss from a subsequent sale.

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We think the decision below should be construed to harmonize with these views, but the possibility that the decision might be interpreted to hold that there can be no reorganization within the meaning of this statute without a merger or consolidation in the technical sense has caused some concern, for the reason that the administrative construction of the statute has not so restricted it. We are informed that the consistent administrative construction of Section 203 (h) (1) (A) by the Treasury Department has always been that the acquisition of substantially all the property of a corporation (even though not amounting to a merger or consolidation) is a "reorganization" within the statute, provided the transaction meets the other statutory requirements. In thus administering the statute the Treasury Department has construed the parenthetical clause of Section 203 (h) (1) (A) as enlarging for the purpose of the statute the commonly understood meaning of "merger or consolidation" and thus bringing some transactions within the term "reorganization" which technically are not mergers or consolidations.[2] That seems to be its natural meaning and this construction is strengthened by the definition of the term "including" in

[2] The definition of the term "reorganization" first appeared in Section 202 (c) (2) of the Revenue Act of 1921, and the legislative history shows that the parenthetical clause was added by the Senate apparently for the purpose of enlarging the definition. (H. Rep. 486, 67th Cong., 1st Sess., p. 17, Amendment No. 47.)

Section 2 (b) of the Act (*infra*, p. 33), which indicates that it is not to be given a restrictive application.[3] Since the decision below can not be given the effect of excluding from the term "reorganization" all transactions which technically are not mergers or consolidations, without disregarding the parenthetical clause, we think the interpretation of the decision which we have suggested above is to be preferred.

(3) "*Stock or securities.*"—This construction of the statute is likewise consistent with the requirement of Section 203 that the consideration shall include stock or securities in another corporation which is a party to the reorganization. The Board of Tax Appeals held that the notes in this case did not constitute "securities" within the

[3] In *Prairie Oil & Gas Co.* v. *Motter*, D. Kan., decided September 17, 1932, not yet officially reported, Prentice Hall Federal Tax Service, 1932, vol. 1, p. 2099.229, it was held that the word "including" in Section 203 (h) (1) (A) is a word of enlargement rather than a word of limitation.

The decision in the *Prairie Oil & Gas case* is in no way inconsistent with our position as to what constitutes a reorganization. The Prairie Oil & Gas Co. purchased all of the stock of the Olean Petroleum Co., and the next day dissolved the Olean Co. and assumed direct ownership of its assets. There was thus a complete continuity of ownership, and a reorganization within the definition of the statute. We do not rely on the decision in so far as it may be regarded as holding that a transfer of stock or assets for cash meets the requirement of the statute that an exchange is a necessary element of a tax-free transaction, nor was that contention made in the District Court by the Government.

meaning of the statute, because the statute clearly contemplated something different from purchase price obligations. In the *Cortland Specialty Company case, supra,* it was likewise held that a series of unsecured notes all payable within fourteen months from the transfer were not securities within the meaning of Section 203, the court saying (p. 940):

> The very reason that section 203(e) requires that some of the property received in exchange should be "*stock or securities*" is to deprive a mere sale for cash of the benefits of an exemption and to require an amalgamation of the existing interests. * * * The word "securities" was used so as not to defeat the exemption in cases where the interest of the transferor was carried over to the new corporation in some form.

The notes in the instant case were secured by bonds of the Forida West Coast Ice Company, which were secured by the properties acquired by that company from petitioner and the Citizens Company. (R. 18.) The terms of the bonds do not appear. Assuming for present purposes that some types of bonds would be "securities" within the meaning of the statute, petitioner did not own the bonds, and its interest in the assets which secured them had changed substantially. Its right to look to the bonds and ultimately to the entire property of the obligor in the event that the notes were not paid

was quite different from its right as owner of its own property. Moreover, under the sales agreement different collateral could have been given (R. 15), and it was only in the event that Florida West Coast Ice Company bonds were pledged that petitioner would have had even this remote connection with the property it was selling. Accordingly, even assuming that petitioner can be said to have had a plan of reorganization, it was no necessary part of that plan that petitioner should continue to have any interest whatsoever in the property of which it was disposing. It is implicit in the statute that the transaction shall result merely in a change of form and not in one of substance and that the corporation which has transferred its assets shall receive stock or securities which represent a continuing interest in the assets which have been transferred. Clearly, the notes in this case did not represent any interest of this character.

The conclusion that the notes in the instant case were not "securities" within the meaning of the statute does not imply that the term "securities" may not include bonds and similar obligations of the transferee corporation. While we believe that the term as used in Section 203 should, in general, be construed as limited to obligations which are a part of the permanent financial structure of the transferee corporation, such as long-term bonds, it is unnecessary for present purposes to determine

the full scope of the term. We believe that it should not be extended to include mere purchase money obligations, even though these obligations are secured by bonds of the purchaser. There is a substantial difference between the interest represented by a long-term bond, involving a permanent investment in the business, and a purchase money obligation which the transferor intends to and does liquidate in a comparatively short time, without any concern for the future operation of the property as a business.[4] We submit that the purpose of Congress to ignore for tax purposes transactions which result merely in a change of form should not be extended to include this transaction, where the petitioner has parted with all permanent proprietary interest in the property disposed of.

(4) *"Plan of reorganization."*—The record contains no express finding that the transfer of the petitioner's assets in this case was pursuant to any "plan of reorganization." If there was any plan of reorganization it was not the petitioner's plan. The Fitkin interests desired to acquire the business

[4] Our contention that purchase money notes are not "securities" is of course limited to situations arising under the reorganization provisions. In construing statutes having a different purpose it may well be that notes should be regarded as securities, and the Bureau of Internal Revenue has so held in G. C. M. 2000, VI–2 C. B. 248. This Court has recently pointed out that the same word may have different meanings when used more than once, even in the same section of the statute. *Atlantic Cleaners & Dyers, Inc.* v. *United States*, 286 U. S. 427, 433.

of the petitioner and another company. (R. 13.) Their interests, not the taxpayer, caused the formation of a corporation to take title to the latter's property. (R. 16.) The petitioner's plan, so far as it had any, was that its affairs would be wound up, its assets distributed, and that it would be dissolved. (R. 13–14.) While undoubtedly the statute does not require a formal "plan of reorganization" such as is often prepared in a corporate reorganization, there apparently was no plan of reorganization, formal or informal, in which petitioner was directly involved. Of course, the fact that the statute might be satisfied by an informal plan does not justify disregarding that requirement of the statute here where, apparently, there was no "plan of reorganization" at all.

(5) *"Party to the reorganization."*—If there was no reorganization within the meaning of the statute, then, of course, the petitioner was not a party to a reorganization.

Furthermore, the statute includes a definition of the term "a party to a reorganization" which, while not exclusive, is nevertheless significant so far as the present situation is concerned. Section 203 (h) (2) provides as follows:

> The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number

of shares of all other classes of stock of another corporation.

It will be noted that the definition specifically includes both parties in the case of one of the transactions mentioned in Section 203 (h) (1) (A) but does not refer to the transaction which covers this case. Section 203 (h) (1) (A), in the parenthetical clause, deals with two transactions, namely, (1) the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, and (2) the acquisition by one corporation of substantially all the properties of another. Section 203(h)(2) provides that in the case of the first transaction both corporations shall be deemed to be parties to the reorganization, but it is silent as to whether both corporations in the second transaction are to be deemed parties to the reorganization.

In our view (1) there was no "exchange" of property, (2) there was no "reorganization" within the statutory definition, (3) the consideration did not include any stock or securities in another corporation, a party to the reorganization, and (4) there was no "plan of reorganization." Since these four conditions of the statute are not satisfied we think it is clear that the case does not fall under any of the exceptions in Section 203 and therefore that Section 203 (a) requires that the gain be recognized.

The language of the statute seems to us so clear that we do not believe that a resort to legislative history for light on its meaning or the purpose of Congress is necessary. See *United States* v. *Shreveport Grain & Elevator Co.*, No. 19, October Term, 1932, decided November 7, 1932. But the petitioner has quoted at length from the Statement of Changes Made in the Revenue Act of 1921, which was prepared by the Treasury Department when the Revenue Bill of 1924 was being drafted.[5] It is true that there is language in this Statement which supports the view that a transfer of assets for cash may be nontaxable. But it does not appear that this report was accepted by either the Senate or House. The paragraph quoted by the petitioner (Br. 13), which contains the language most favorable to its position, was not incorporated in the House or Senate Committee reports. And the House and Senate Committee reports themselves show that Congress took the contrary view by limiting Section 203 (e) (1) to transfers "for stock and securities * * * *and* cash." (House Report No. 179, 68th Cong., 1st Sess., p. 15; Senate Report No. 398, 68th Cong., 1st Sess., p. 16; italics ours.)

Furthermore, the Statement of Changes upon which the petitioner relies, stated in discussing Section 204, relating to the basis for determining gain

[5] The reorganization provisions of the 1926 Act are in substance the same as those in the 1924 Act, to which the material here referred to relates.

or loss (see Klein, Federal Income Taxation, Appendix D, pp. 303–304):

> The provisions of section 203 of the draft that no gain or loss is recognized from certain exchanges do not grant an exemption and are not so intended. These provisions are based upon the theory that the types of exchanges specified in section 203 are merely *changes in form and not in substance* and consequently should not be considered as affecting a realization of income at the time of the exchange. In other words, these provisions result not in an exemption from tax but in a postponement of tax *until the gain is realized by a pure sale* or by such an exchange as amounts to a pure sale. (Italics ours.)

This identical language was adopted in both the House and Senate Reports. (House Report No. 179, 68th Cong., 1st Sess., p. 16; Senate Report No. 398, 68th Cong., 1st Sess., pp. 17–18.)

The language thus adopted by the Committees shows plainly the intention of Congress that a transaction such as that involved in the present case shall not be exempt from tax. The outright sale of assets does not fall within the requirement that Section 203 applies only to "changes in form and not in substance;" and here the gain has been "realized by a pure sale" so that there is no occasion for a "postponement of tax."

Nor is there anything in the regulations to support the petitioner's position. The petitioner

prints twice (Br. 21–22, 31–32) a partial quotation from Article 1574 of Regulations 65 and 69, and this partial quotation read apart from its setting does seem to lend some aid to the petitioner's contentions. But when Article 1574 is examined in its entirety (see *infra*, pp. 37–39), it is clear that it relates only to transfers for which the sole consideration is stock or securities. The provision of the regulations which deals with transfers in consideration of "stock or securities * * * *and* other property or money" (italics ours) is Article 1575 of Regulations 69 (*infra*, pp. 39–41). Article 1575 provides that transfers of property in return for stock or securities *and* other property or money, where all the other conditions of the statute are satisfied, are nontaxable if the other property or money received is distributed pursuant to the plan of reorganization. There is no regulation which provides that an outright sale is exempted from taxation by Section 203.

The petitioner is not helped by any of the several administrative rulings, which it cites, and from which it quotes. In G. C. M. 3827, VII–2 Cumulative Bulletin 114 (December, 1928), the consideration received by the taxpayer in exchange for its business included preferred stock as well as cash. In the transaction involved in G. C. M. 7472, IX–1 Cumulative Bulletin 184 (June, 1930), the only consideration received by the taxpayer in exchange for its assets was stock. In I. T. 2542,

IX-2 Cumulative Bulletin 126 (December, 1930), stock of the taxpayer was exchanged for stock in another corporation. In G. C. M. 8565, IX-2 Cumulative Bulletin 127 (December, 1930), the gain upon the transaction was held taxable. In G. C. M. 1753, VI-1 Cumulative Bulletin 138 (June, 1927), the sole consideration received by the taxpayer in exchange for its assets was stock. While G. C. M. 2000, VI-2 Cumulative Bulletin 248 (December, 1927), held farmers' mortgage notes to be securities under the Federal Farm Loan Act, the question arose under Section 234 (a) (2) of the Revenue Act of 1921 (relating to the deduction from a corporation's gross income of interest on indebtedness incurred "to purchase or carry obligations or securities * * * the interest upon which is wholly exempt from taxation"), a question which obviously has no connection with the proper construction of Section 203 of the Revenue Act of 1926. In G. C. M. 3291, VII-1 Cumulative Bulletin 203 (June, 1928), stock in one corporation was exchanged for stock and debenture notes in another.

The petitioner has printed in its brief quotations from each of these administrative rulings. Considered apart from their context and isolated from the facts to which they apply, they appear to lend support to petitioner's argument which is lacking upon examination of the rulings in their entirety. As we have shown, none of these administrative rulings involve the question presented in this case.

Petitioner also relies on *Williams* v. *Commissioner,* 44 F. (2d) 467 (C. C. A. 8th), which is cited as in direct conflict with the decision below. An examination of the opinion shows that it did not deal with the subject of "reorganization" and it clearly has no bearing on the problem presented here. The taxpayer involved, a stockholder, was held taxable on the transaction there considered.

II

IN ANY EVENT, THE DOWN PAYMENT WAS NOT DISTRIBUTED WITHIN THE MEANING OF SECTION 203(e)(1) AND TO THAT EXTENT THE GAIN IS TAXABLE

Assuming for the purpose of argument that the transaction in question satisfied all of the requirements of the statute heretofore discussed, there still remains for consideration the question of the taxability of the down payment of $400,000 in cash. Section 203(e) of the Act (*infra,* pp. 35–36) provides that even though a transaction would otherwise be one on which no gain is to be recognized, if part of the consideration received is money the gain shall be recognized in an amount not exceeding the amount of cash received—

> If the corporation receiving such * * * money does not distribute it in pursuance of the plan of reorganization, * * *.

We submit that the word "distribute" as used in this statute does not cover the payment of the corporation's debts, but means a distribution to the

stockholders of the corporation. The findings show that no part of the cash payment of $400,000 was distributed to the petitioner's stockholders; it was used in its entirety for the payment and discharge of debts and obligations of the taxpayer. (R. 16–18.) A creditor who gives up his claim against the corporation receives "payment," not a "distribution."

Bearing in mind that the entity making the distribution is the corporation itself, it would appear that the usual and ordinary meaning of the word "distribute" would be to pay money or transfer property ratably among the stockholders of the corporation. Section 201 of the same statute defines the term "dividend" as a "distribution made by a corporation to its shareholders." The fact that Section 203 (g) provides that a distribution of stock or securities in pursuance of a reorganization shall not be considered as a distribution within the meaning of Section 201 without mentioning a distribution of money is persuasive that Section 203 deals with the same sort of distribution as Section 201. This appears to be the "adequate provision" made in the statute for cases in which income is actually realized by the stockholders, which is referred to in Article 1574 of Treasury Regulations 69 (*infra*, p. 39).

Consideration of the purpose of the statute also strongly indicates that the payment of the selling corporation's debts is not a "distribution." When

there is a reorganization and the corporation is a mere conduit to pass the gain realized on to stockholders, then the stockholders are taxed on the gain. But when the proceeds of the sale are retained by the corporation and used for corporate purposes, the corporation itself has realized the gain; it is not a mere conduit to pass on the gain to the stockholders, and the profit will escape taxation unless it is taxed to the corporation. The payment of corporate debts is obviously a corporate purpose. So much of the profit from the sale as is used in the payment of debts will never be taxed unless it is taxed to the corporation, for it never reaches the stockholders, and it is not taxable as such to the creditors.

A reference to the Committee Reports in connection with the Revenue Act of 1924 shows unmistakably the legislative intent to limit the word "distribute" to payments of money or transfers of property to the stockholders of the corporation making the distribution. H. Rep. No. 179, 68th Cong., 1st Sess., p. 15, contains the following:

> Section 203 (e): There is no provision of the existing law which corresponds to subdivision (e) of the bill, nor has the Treasury Department ever ruled officially on the type of case covered by that subdivision. The subdivision provides that if a corporation in connection with a reorganization transfers its assets to another corporation, a party to the reorganization, for stock and securities

> of the same corporation and cash, then no gain or loss to the transferor is recognized, if it distributes the cash *to its stockholders.* But if the selling corporation fails to distribute the cash *to its stockholders* then the gain or loss is to be recognized. In other words, if the corporation which sells its assets in connection with the reorganization acts merely as a *conduit* in passing the proceeds of the sale on *to its stockholders,* no gain to the corporation is to be recognized, but if it retains all or any of the proceeds with the result that the transaction is in substance a real sale, then all or a part of the gain shall be recognized. (Italics ours.)

Thus even where the whole gain from a reorganization is not to be recognized for tax purposes (because of the receipt and distribution of stock or securities), it seems quite clear that Congress intended that any cash received in the transaction was to be taxed either to the corporation or to the stockholders, depending upon whether or not the cash was distributed to the stockholders.

While part of the cash was paid directly to creditors of the petitioner, these payments for its benefit are the equivalent of actual receipt by the petitioner. *Old Colony Trust Co.* v. *Commissioner,* 279 U. S. 716. There is no dispute that the profit from this transaction exceeded $400,000. Therefore, under Section 203 (e) (2) it would be necessary in any event to recognize that amount of gain as subject to tax.

CONCLUSION

The decision of the Circuit Court of Appeals should be affirmed.

Respectfully submitted.

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APPENDIX

The Revenue Act of 1926, c. 27, 44 Stat. 9, 11, 12, provides in part an follows:

SEC. 2. (a) When used in this Act—

* * * * *

(b) The terms "includes" and "including" when used in a definition contained in this Act shall not be deemed to exclude other things otherwise within the meaning of the term defined. (U. S. C. Sup. V, Title 26, Sec. 1262.)

SEC. 202. (a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized.

* * * * *

(d) In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 203.

* * * * *

(U. S. C. Sup. V, Title 26, Sec. 933.)

SEC. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

(b) (1) No gain or loss shall be recognized if property held for productive use in trade

or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment, or if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(2) No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(3) No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(4) No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

(c) If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

(d) (1) If an exchange would be within the provisions of paragraph (1), (2), or (4) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

(e) If an exchange would be within the provisions of paragraph (3) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such

paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

(f) If an exchange would be within the provisions of paragraph (1), (2), (3), or (4) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(g) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, shall not be considered a distribution of earnings or profits within the meaning of subdivision (b) of section 201 for the purpose of determining the taxability of subsequent distributions by the corporation.

(h) As used in this section and sections 201 and 204—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least

a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(i) As used in this section, the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation. (U. S. C. Sup. V, Title 26, Sec. 934.)

Regulations 69, promulgated August 28, 1926, under the Revenue Act of 1926, contained the following provisions:

ART. 1574. *Exchanges in connection with corporate reorganizations.*—Since corporate reorganizations which result only in a change in form and which do not substantially affect the property interests, either of the shareholders or of the corporations, may be required or may be made desirable by business conditions, State laws, or other causes, the statute provides that no gain or loss shall be recognized if, in pursuance of a

plan of reorganization, stock or securities in a corporation a party to a reorganization are exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization, or if, in pursuance of a reorganization plan, a corporation a party to a reorganization exchanges property solely for stock or securities in another corporation a party to the reorganization. If two or more corporations reorganize, for example, by—

(1) The dissolution of corporation B and the sale of its assets to corporation A,

(2) The sale of its property by B to A,

(3) The sale of the stock of B to A,

(4) The merger of B into A,

(5) The consolidation of A and B,

(6) The acquisition by A of a majority of the voting stock and a majority of the total number of shares of all other classes of stock of B or of substantially all of the properties of B, or

(7) The transfer by A of all or a part of its assets to B where immediately after the transfer A or its shareholders are in control of B, then no taxable income is received from the transaction by corporation A or B if the sole consideration for the transfer of the assets in stock or securities of corporation A or B; and no taxable income is received from the transaction by the shareholders of either corporation A or corporation B if the sole consideration received by the shareholders is stock or securities of corporation A or B.

Furthermore, if the reorganization is accomplished by the transfer by corporation A of a portion of its assets to corporation B in exchange for the stock of corporation B, and corporation A distributes to its shareholders the stock of corporation B, no taxable income is realized by the shareholders

from the receipt of such stock. (See article 1576.)

In conformity with the principle of ignoring for tax purposes those reorganizations which result merely in a change in form, the statute provides further that the stock received by the shareholders in connection with the reorganization shall have the same basis for the purpose of determining gain or loss from its subsequent sale as the stock surrendered by them, and that the assets acquired by a corporation a party to the reorganization shall have the same basis for determining depletion, exhaustion, wear and tear, obsolescence, and gain or loss from subsequent sale as they had in the hands of the corporation from which they were acquired. (See articles 1596–1598.)

Adequate provision is made in the statute for cases in which income is actually realized by the shareholders in connection with the reorganization through the receipt of cash or property other than the stock of a corporation a party to the reorganization. (See article 1575.) While placing no obstacle in the way of genuine reorganizations, the statute does not allow the use of reorganizations to avoid the tax.

Records in substantial form, showing the basis of the stock or property exchanged, and the amount of property or money received in exchange, must be kept to enable the determination of gain or loss from a subsequent disposition of the stock or property received or exchanged.

ART. 1575.—*Exchanges in reorganizations for stock or securities and other property or money.*—If stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged for stock or securities in such cor-

poration or in another corporation a party to the reorganization and other property or money, the gain, if any, to the recipient will be recognized in an amount not in excess of the sum of the money and the fair market value of the other property. No loss from such an exchange will be recognized, however. (See section 203(f).) If a distribution of property or money in the course of a reorganization is otherwise within the provisions of this paragraph, but has the effect of the distribution of a taxable dividend, there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized under this paragraph as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) as a gain from the exchange of property, the remainder of the gain recognized under this paragraph.

Examples.—(1) A, in connection with a reorganization, exchanges in 1925 a share of stock in the X company, purchased in 1918 for $100, for (a) a share of stock in the Y company a party to the reorganization, which has a fair market value of $90, and (b) $20 cash. The gain from the transaction, $10, is recognized and taxed to A. See article 1596 for the basis for determining gain or loss from a subsequent sale.

(2) The X corporation has a capital of $100,000 and earnings and profits of $50,000 accumulated since February 28, 1913. The X corporation in 1925 transfers all its assets to the Y corporation in exchange for the issuance of all Y's stock and the payment of $50,000 in cash to the shareholders of corporation X. A, who owns one share of stock in X, for which he paid $100, receives a share of stock in Y worth $100 and in

addition $50 in cash. A will be liable to the surtax on $50.

If, in pursuance of a plan of reorganization, property is exchanged by a corporation a party to a reorganization for stock or securities in another corporation a party to the reorganization and other property or money, then, if the other property or money received by the corporation is distributed by it pursuant to the plan of reorganization, no gain to the corporation will be recognized. If the other property or money received by the corporation is not distributed by it pursuant to the plan of reorganization, the gain, if any, to the corporation from the exchange will be recognized in an amount not in excess of the sum of the money and the fair market value of the other property so received which is not distributed. In either case no loss from the exchange will be recognized. (See section 203 (f).)

Articles 1574 and 1575 of Regulations 65, issued under the 1924 Act, are substantially the same so far as here relevant as Articles 1574 and 1575 of Regulations 69, set out above.

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